KPMG

Bay Area Air Quality Management District Cost Recovery Study

Final Report:

Phase One - Evaluation of Fee Revenues and Activity Costs

February 16, 1999

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APPENDICES

EXECUTIVE SUMMARY

The Bay Area Air Quality Management District (the District) addresses air pollution problems created by stationary sources within the nine Bay Area counties. The District's air pollution control programs are primarily funded by regulatory fees and county property taxes. Until approximately 1991, the District was able to fund its operations and maintain adequate fund balances and reserves. However, in the past few fiscal years the District has experienced budget shortfalls. As operating expenditures started exceeding revenues, the District curtailed spending, scaled back programs, and spent down its budget reserves.

Realizing that it had a structural problem in its budget, the District hired KPMG LPP (KPMG) to conduct a cost recovery study to answer a basic question: ***Are fee revenues sufficient to offset the costs of associated activities?*** The answer, simply put, is ***no***. Fees are not recovering the District's costs of regulatory activities because of several factors. These include the following:

- **Fee rates have not kept up with inflation.**
  Although the District is authorized to adjust its fee schedules annually to compensate for the effects of inflation, it has only made three revisions to its fee schedule in the 1990s. The District increased fees 10% in 1991, 1.25% in 1994, and 3.1% in 1998, for a compounded rate of fee increase between 1991 and 1998 of 14.83%. However, the compounded rate of inflation in the Bay Area from 1991 to 1998 was 23.37%, resulting in an 8.54% decline in the District's fee rates since 1990 when adjusted for inflation.

- **The District's fee structure is out of date and does not contribute to full cost recovery.**
  The District adopted its first regulatory fee in 1977. In this first fee and in nearly all of the regulatory fees that it has since enacted, the District calculated the fee amount on the basis of a source's size and potential capacity to produce emissions. The fee amount was not related to how much it cost the District in terms of staff, equipment, and other resources to conduct the activities required to provide the regulatory service associated with the fee. As a result, the District's fee structure does not closely parallel its costs of doing business for certain activities.

- **County revenues and fund balances have been used in the past to offset the misalignment between fee revenues and costs, masking the full extent of revenue shortfalls.**
  For many years, the District relied not only on fees but also on other sources of revenue to support the costs of regulatory activities. The District is unique among air quality agencies in California because it is partially supported by county property tax revenues. County property taxes comprise 37% of the District's budget and are used to support numerous District activities, including: planning, research, public outreach activities, compliance, technical services, administration,

and the District Counsel. County revenues have also been used to offset the costs of regulatory activities that were not recovered through fees.

The District has also been unique among air quality agencies because for many years it enjoyed a healthy fund balance. The fund balance represented a general reserve available to cushion the District against unanticipated financial occurrences. However, beginning in the early 1990s, the District pursued a policy of spending down its fund balance, using it to pay for the costs of regulatory activities not recovered through fees. Today, the District's fund balance is depleted and county revenues must be used to fund not only regulatory activity costs, but other important program priorities such as developing plans to meet new national ozone and particulate matter standards. Therefore, the District no longer has the luxury of having a reserve to use to fund on-going operations.

- **The costs of performing regulatory activities have changed.**
  The District has been successful in encouraging Bay Area industries to use cleaner equipment and processes. With the adoption of new technologies, however, the District now confronts the need to devote more staff effort to monitoring the new equipment and ensuring that cleaner technologies are correctly and consistently operated. Compared to the past, when the bulk of the District's regulatory activities consisted of simpler permits and air pollution control devices, the District now faces a much more extensive and complex regulatory environment in which the costs of permitting, compliance assurance, monitoring, inspection, testing, and enforcement have increased.

These factors are important considerations, but not the only contributors to the gap between the District's fee revenues and activity costs. For example, there may be opportunities for the District to reduce the costs of its activities through making its organizational structures and processes more efficient and cost effective. Although potentially improving the District's overall cost effectiveness was not within the purview of this Phase One report, a workplan to assess this area during Phase Three is included in this document.

To complete this Phase One study of the District's fee revenue sufficiency, KPMG and District staff developed an "activity-based costing" model to estimate the extent of misalignment between fee revenues and related costs. It should be noted that the model relies on numerous assumptions and, consequently, the results from the model are subject to possible over- or under-estimation. In summary, the model's results indicate that the District's fee-related activity costs exceed fee revenues by approximately $7 million for fiscal year 1997-98. Put another way, the District would need to increase its fee revenues by about 60% in order to achieve full cost recovery for its regulatory activities.

This report contains eleven recommendations intended to help the District address this significant misalignment between fee revenues and costs. Recommendations #1.1 through #4 are intended to be implementable in the short-term—that is, within the next few months

to next two years. Recommendations #5 through #8, to be enacted between three to five years from now, were developed to ensure the sufficiency and stability of the District's regulatory fee revenues well into the future. The recommendations are presented below.

Recommendation #1.1: The District should adopt a 9% to 15% fee schedule increase in fiscal year 1999-2000 to begin to provide sufficient fee revenue to fund its regulatory activities.

Recommendation #1.2: The District should consider instituting a policy to make fee adjustments every year to account for inflation.

Recommendation #1.3: The District should undertake further refinement of the ABC model to ensure that significant variances in the specific fee schedules are correct.

Recommendation #1.4: The District should clearly state its policy regarding providing a financial subsidy to small businesses.

Recommendation #2: The District should adopt best practices for capital planning and budgeting, and recover capital costs associated with fee-related activities.

Recommendation #3: The District should enhance the quality and type of data available to managers so that the District can be more accountable for its use of funds.

Recommendation #4: The District should adequately staff programs to ensure that violations are processed and penalties are collected in timely fashion.

Recommendation #5: The District should develop and implement a hybrid fee structure for permit schedules to better recover its cost of regulatory activities.

Recommendation #6: The District should reestablish its fund balance, or "general reserves," to adequate levels.

Recommendation #7: The District should incorporate long-term financial and revenue planning into its strategic plans.

Recommendation #8: The District should consider implementing area-wide/indirect source fees and/or other new fee sources to broaden its fee revenue base.

Sections III and IV of this report contain detailed discussions of the recommendations listed above. The recommendations of this Phase One report are supplemented with two workplans, one to review the District's non-fee revenues and costs, and a second to assess the overall efficiency and cost effectiveness of the District's operations. Taken together, the results of Phase One of the cost recovery study should help the District secure its financial footing and enable it to achieve its critically important public purpose: ensuring clean air for the citizens of the Bay Area.

I. INTRODUCTION

The Bay Area Air Quality Management District at a Glance:

Created: **1955 through the California Health and Safety Code**

Headquarters: **San Francisco, CA**

Employees: **306 budgeted permanent full time equivalent positions in FY 1998-99**

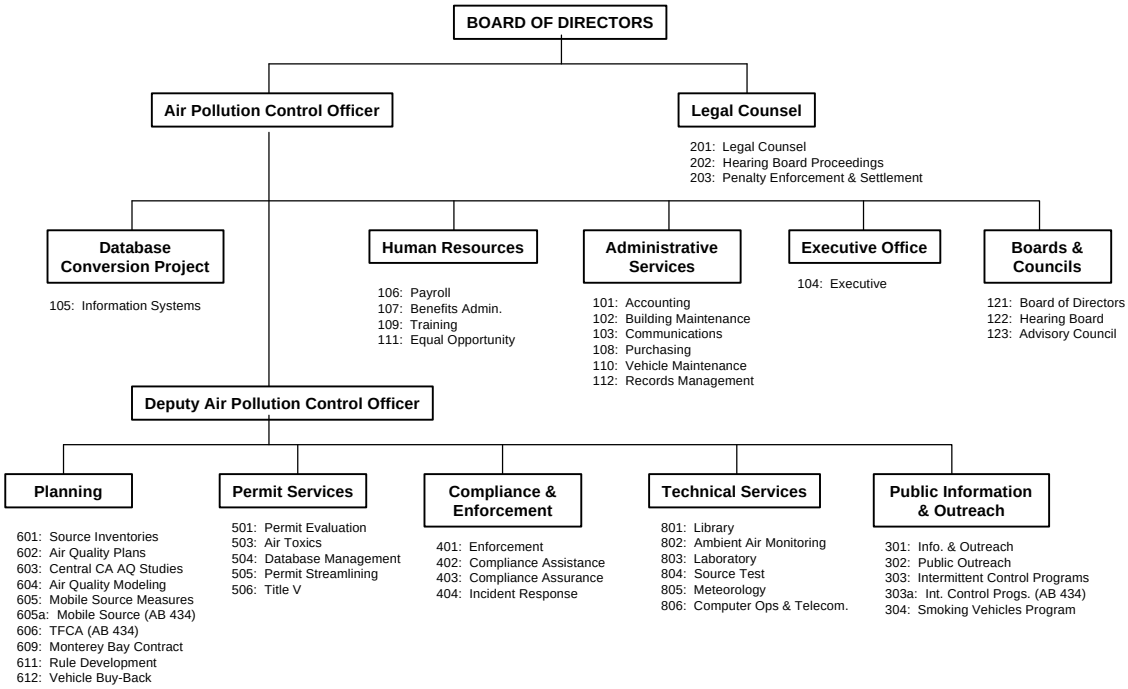
Expenditures: **$30.3 million, not including "pass-throughs," for Fiscal Year 1998-99**

Created by the California Legislature in 1955, the Bay Area Air Quality Management District (the District) is responsible for addressing air pollution problems in the Bay Area created by sources other than emissions from motor vehicles. Its jurisdiction encompasses nine Bay Area counties: Alameda, Contra Costa, Marin, Napa, San Francisco, San Mateo, Santa Clara, southwestern Solano, and southern Sonoma. The District is required by state law to adopt and enforce regulations affecting sources within its jurisdiction in order to achieve and maintain state and federal ambient air quality standards; to enforce relevant state and federal requirements; and to prevent and abate episodes that may affect the health and comfort of the public. The District takes a multi-faceted approach to reducing air pollution in the Bay Area through:

- Developing plans to achieve federal and state health-based air quality standards
- Conducting outreach and forming partnerships with the public and Bay Area businesses to develop air pollution solutions
- Controlling the potential to emit air pollutants at facilities—as large as an oil refinery or as small as the neighborhood dry cleaner—within the Bay Area
- Developing rules and regulations to further reduce air pollution emissions
- Ensuring that facilities comply with District rules and regulations as well as with any applicable permit conditions for that facility.

To conduct its planning, outreach, permitting, compliance, and other regulatory activities, the District relies on nearly 306 employees. Exhibit I-1 presents the District's organization chart.

Exhibit I-1: Bay Area Air Quality Management District Program Organizational Chart



Source: Bay Area Air Quality Management District, Approved Budget for Fiscal Year 1998-99, Appendix A.

District employees are organized into 7 divisions, which are further classified into 48 smaller program groups. District staff have been reduced from a high in 1993-94 of 372 full time equivalent employees (FTE) to its current budgeted personnel expenditure of 306 FTE.

The District's programs are supported by revenue primarily from county property taxes, government grants and subventions, and permit fees. Between 1955 and 1970 the District was funded entirely through property taxes. In 1970, through the California Air Resources Board and the Federal Environmental Protection Agency, state and federal subventions became part of the District's budget. With the passage of Proposition 13, the District was classified as a special district and became eligible for AB-8 funds, which currently make up the county revenue portion of the budget.

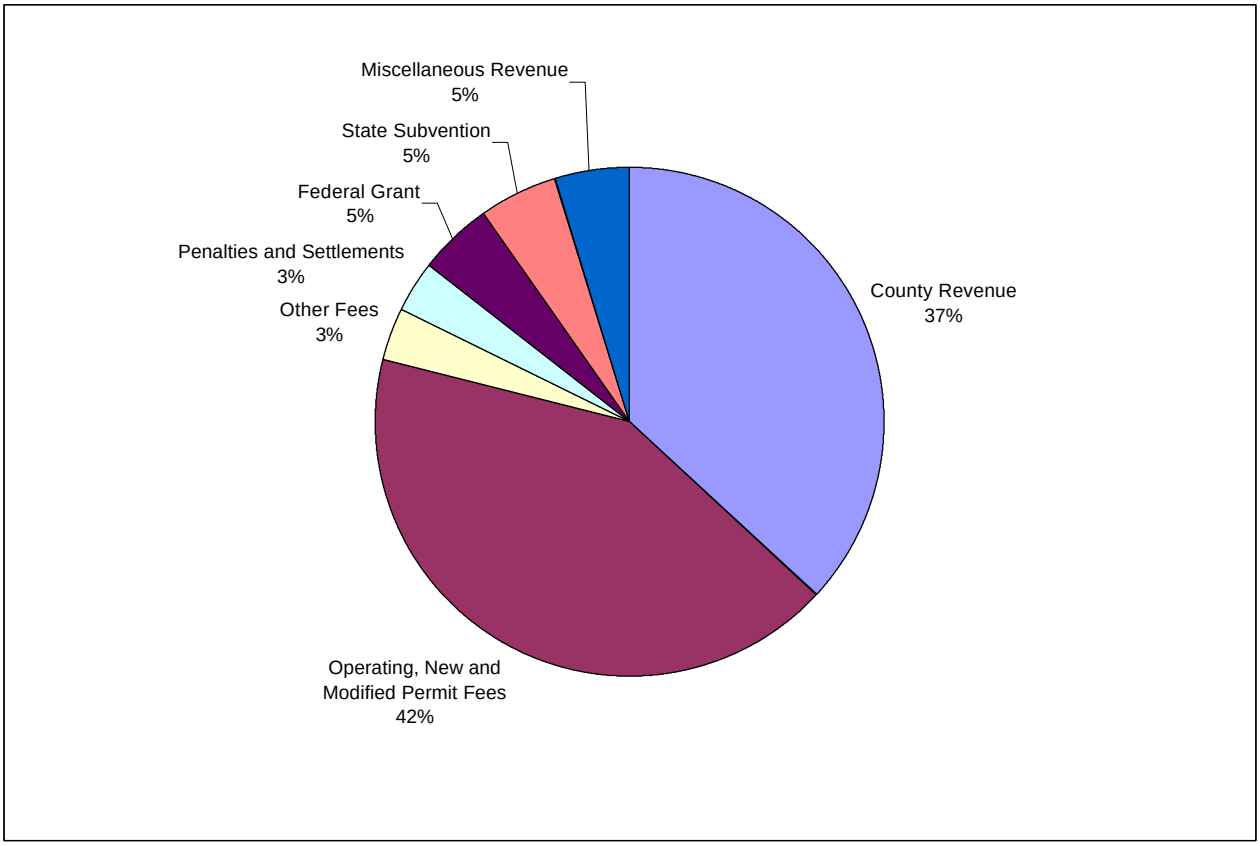
As part of its regulatory oversight, the District can impose a schedule of fees for permits and other services provided to facilities. The California Health and Safety Code authorizes the District to adopt a schedule of permit fees and to recover the full cost of District programs related to those fees.[1] With such authority, the District adopted its first permitting regulation on July 1, 1972[2] and its first regulatory fee in 1977. Today, it regulates and permits approximately 5,200 industrial facilities and over 2,400 gasoline

[1] Health and Safety Code section 42311(a).
[2] *Bay Area 1997 Clean Air Plan and Triennial Assessment*, December 1997, page H-53.

service stations, and includes 22,000 operation permits. Appendix B contains a detailed listing of each fee schedule and the methodology used to calculate fees for each fee schedule.

In fiscal year 1997-98, the District's general fund revenues were approximately $25 million. Property taxes, which comprise approximately one-third of the District's revenue, are affected by property values and the economic health of the region, and have increased modestly in recent years. However, permit revenues, which represent approximately 42% of revenues, have slightly declined. The District's 1997-98 revenues are shown in Exhibit I-2.

Exhibit I-2: District 1997-98 General Fund Revenues



Source: Bay Area Air Quality Management District Fiscal Year 1997-98 Unaudited Year-End Financial Statement.
Notes: Figures do not include Transportation Fund for Clean Air (AB 434) Revenues.

The District's preliminary financial data for fiscal year 1997-98 indicates that expenditures exceeded revenues by approximately $700,000. This is the most recent year in which this shortfall has occurred; indeed, the District experienced a significant budget deficit of nearly $3 million in fiscal year 1996-97. Part of the cause of the District's financial difficulties has been the policy decision to finance the District's operations using its fund balance, rather than increasing permit fees to reflect inflation and other cost increases to

the District. Beginning in 1991 and continuing until 1998, the District pursued a policy of spending down its fund balance and making only minor cost of living adjustments to permit fee schedules.

The fiscal year 1998-99 budget submitted to the District's Board of Directors stated the case plainly: "the District faces a lean year beginning July 1998." In her report to the Board, the Air Pollution Control Officer presented the cost-cutting measures—including a hiring freeze and voluntary reduced work weeks—necessary to balance the budget. The fiscal year 1998-99 District budget was balanced without using general reserves to fund the District's operating expenditures. From this point on, the District's current expenditures would have to be entirely supported by current revenue.

The Cost Recovery Study

The fiscal year 1998-99 budget focused attention on creating a sustainable level of revenue to support the District's regulatory efforts and achieve mandates. As part of its initiative to ensure the long-term stability of revenues, the District sought to undertake a cost recovery study to help identify opportunities for a more sustainable financial future. The District had not undertaken a comprehensive assessment of the adequacy of its fee schedules to recover costs of fee-related activities for several years.

In August 1998, the District issued a public request for proposals (RFP) for an outside contractor to conduct this cost recovery study. In October 1998, it approved a contract to retain the independent consulting and accounting firm of KPMG LLP (KPMG) to conduct the study.

Cost Recovery Study Approach

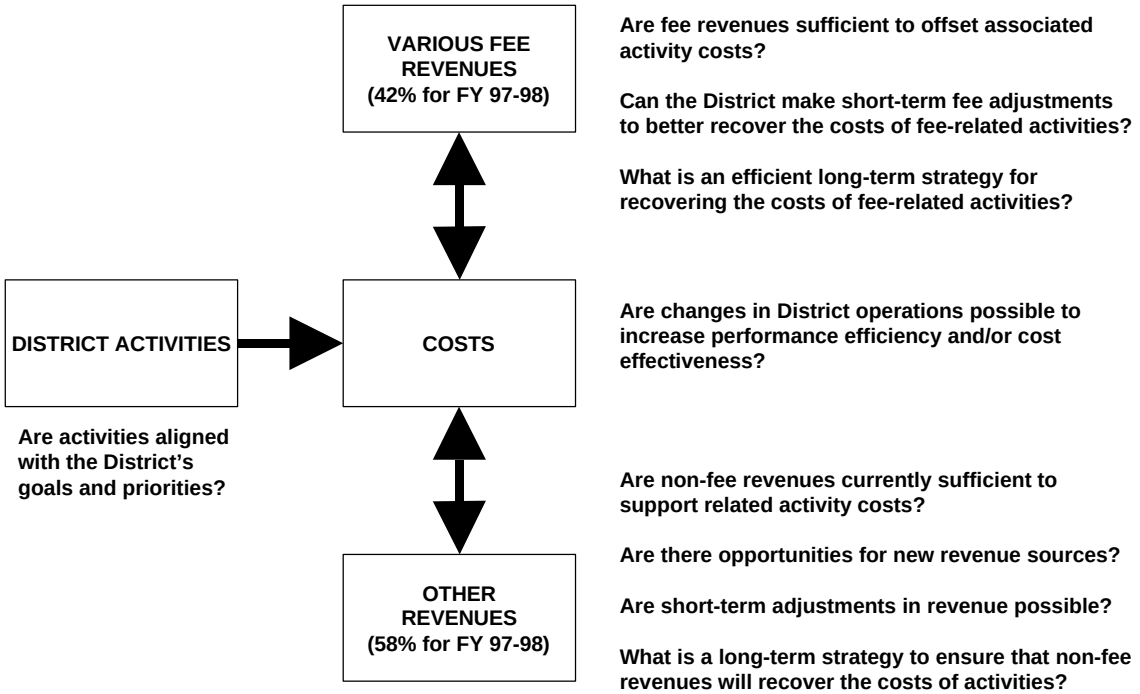
Based on the requirements of the District's RFP, KPMG developed a three-phase approach to achieve the objectives of the cost recovery study.

- Phase One: Analyze the alignment between fee revenues and associated activity costs
- Phase Two: Analyze the alignment between non-fee revenues and costs
- Phase Three: Identify opportunities for greater efficiency and cost effectiveness.

This report represents the completion of Phase One of the cost recovery study. The successful completion of all three phases of this study should enable the District to define a comprehensive, specific, realistic, and defensible strategy to create a reliable and sufficient revenue stream to support the District's current and future activities.

The three phases of the study are intended to focus on finding answers to the fundamental questions about the District's revenue adequacy, as well as the efficiency of District activities. Studying the interrelationships among the District's activities, costs, and revenues requires developing answers to questions about how well each of those elements are aligned. KPMG's approach is conceptualized in Exhibit I-3.

Exhibit I-3: Questions to be Answered in Phases One, Two, and Three of the Cost Recovery Study



Source: Bay Area Air Quality Management District Fiscal Year 1997-98 Statement of Revenue, Unaudited Year-End Financial Statement; and KPMG analysis.

Phase One of the study focuses on answering the three questions associated with fee revenues:

- Are fee revenues sufficient to offset associated activity costs?
- Can the District make short-term fee adjustments to better recover the costs of fee-related activities?
- What is an efficient long-term strategy for recovering the costs of fee-related activities?

The workplan presented in Section V of this report, and to be completed as Phase Two of this cost recovery study, focuses on answering the four questions associated with other revenues:

- Are non-fee revenues currently sufficient to support related activity costs?

- Are there opportunities for new revenue sources?
- Are short-term adjustments in revenue possible?
- What is a long-term strategy to ensure that non-fee revenues will recover the costs of activities?

Finally, Phase Three of the study focuses on answering the two questions related to the District's activities and costs:

- Are activities aligned with the District's goals and priorities?
- Are there opportunities to enhance the District's performance efficiency and cost effectiveness?

Executing Phase One

This report represents the completion of Phase One. Phase One had three major objectives: first, to analyze the extent of alignment between the revenues generated by fees and the costs of the fee-related activities conducted. Phase One's second objective was to identify recommendations to help improve the alignment between the District's fee revenues and activity costs. Phase One's third objective was to develop two detailed workplans, the first to enable the District to assess its non-fee revenues and costs, and the second to analyze the efficiency and cost-effectiveness of District activities. These workplans would guide the execution of Phases Two and Three of this cost recovery study. KPMG completed five major tasks, as listed below, to achieve the objectives for Phase One:

Task 1: Conduct Project Management
Task 2: Analyze the District's Fee Structure
Task 3: Develop Workplan for the Review of Non-Fee District Revenues
Task 4: Develop Workplan to Assess Opportunities for Stabilizing or Reducing Costs
Task 5: Develop Communication Plan
Task 6: Prepare Report.

Tasks 1 and 5 encompassed the activities necessary to successfully manage, coordinate, and communicate about the project. Tasks 2 through 4 detailed the data gathering and analytical steps of the cost recovery study. One important activity conducted as part of this project but not appearing as a separate task in the above list was benchmarking. Using feedback from the Advisory Group, KPMG selected "peer" air quality regulatory agencies against which the District's current fee structure and other aspects of operations were compared. These other air quality agencies were:

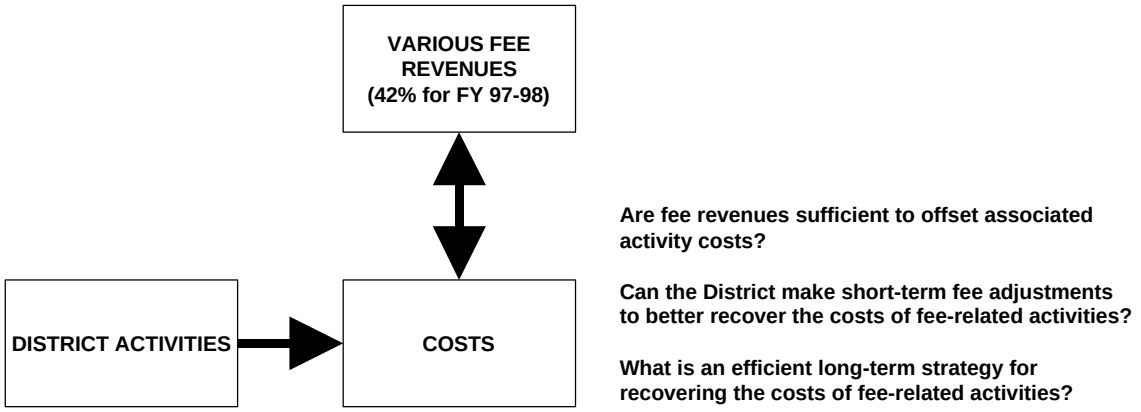
- Sacramento Metropolitan Air Quality Management District
- San Joaquin Valley Unified Air Pollution Control District
- Santa Barbara County Air Pollution Control District

- South Coast Air Quality Management District.

Regulatory structures in these other air quality regulatory agencies were examined to identify fee systems and approaches that might successfully be transferred to the unique circumstances within the Bay Area.

KPMG's primary analytical approach for the Phase One study, conceptualized in Exhibit I-4, was to assess the relationships among the District's fee revenues, activities, and costs. KPMG's analysis was to focus on answering the three key questions: first, are the District's fee revenues sufficient to offset the cost of associated activities? Second, can the District make quick adjustments to recover the costs of fee-related activities? Finally, what strategies can help ensure the long-term alignment of fee-related activity costs and revenues?

Exhibit I-4: Phase One: Determine Relationship Among Activities, Costs, and Fee Revenues at the District



Source: Bay Area Air Quality Management District Fiscal Year 1997-98 Statement of Revenue, Unaudited Year-End Financial Statement; and KPMG analysis.

To answer the questions presented in Exhibit I-4, KPMG performed the following activities:

- Reviewed regulations relating to the structure and administration of District fees
- Interviewed District managers and staff about fee-related activities, processes, costs, and revenues
- Developed an activity based costing (ABC) model to accumulate the costs and revenues associated with fee-related activities
- Benchmarked four other California air quality districts to get comparative information.

Section II of this report presents the results of the analysis to determine the alignment between District fee revenues and associated activity costs. Having identified where the

District's fee revenues appear to be insufficient, KPMG's analysis in Section III identifies short-term recommendations to correct fee revenue and cost misalignments in the next four months to two years. Section IV presents long-term opportunities to ensure the future sustainability of fee revenues.

This report also contains two workplans to assist the District in analyzing non-fee revenues as well as the overall efficiency and cost effectiveness of District operations. Section V of this report presents a workplan to analyze the other, non-fee revenues received by the District and to determine whether revenues are currently sufficient to support programs. To develop this workplan, KPMG obtained information from District managers and staff, studied financial documents, and obtained comparative information from other air quality districts. The workplan should allow the District to identify through benchmarking and other research whether additional opportunities for revenue or financing are available. In so doing, the District will be able to propose short-term solutions to adjust non-fee revenues to needed levels, as well as a long-term strategy for ensuring that the District's non-fee revenue sources are maintained.

The workplan presented in Section VI should allow the District to assess the efficiency and cost-effectiveness of its current activities. First, the workplan contains steps to determine whether the District is performing the right activities—whether its current priorities link back to the District's mission, goals and objectives. If an activity is consistent with the District's strategic direction and should be performed, the next question is, how efficiently does the District perform it? The workplan contains tasks requiring the analysis of cost accounting and other data to identify the costs of activities. The reasonableness of these costs will be examined and compared against peer air quality regulatory agencies to recommend improvements in the District's approach to cost management and review. Finally, the workplan contains elements to develop a framework that the District may use on an ongoing basis to continually assess its activities, their costs, and approaches to achieve cost effectiveness.

II. ALIGNMENT BETWEEN FEE REVENUES AND COSTS

History of Fees at the District

The District has been granted authority under the California Health and Safety Code to adopt a schedule of fees for the evaluation, issuance, and renewal of permits to cover the costs of the District program related to stationary sources. The Health and Safety Code further states that any such fees not exceed, for any fiscal year, the actual costs for district programs for the immediately preceding fiscal year with an adjustment not greater than the change in the annual California Consumer Price Index.

In fiscal year 1977-78, the Board approved the District's first fee—for new source permits. Since then, the Board has approved various other types of fees—for solvent sources, semiconductor sources, and others—as well as occasionally adjusted the permit fee rates to compensate for inflation. All fees are reviewed and approved by the District's 20-member Board of Directors. The fees that have been approved by the Board of Directors are maintained in Regulation 3 of the District's Rules and Regulations.

Between 1990 and 1998, fee revenue from stationary source operating permits has declined even as costs have steadily increased through inflation and growing demands on District resources and activities. The District does not have mechanisms in place to trigger automatic fee adjustments to compensate for inflation. Consequently, most facilities have only had their fees increased three times in the 1990s: 10% in 1991, 1.25% in 1994, and 3.1% in 1998. For purposes of context and comparison, over the same period, the Consumer Price Index for Urban Wage Earners in the San Francisco/Oakland/San Jose area has risen between 1.4% and 4% per year.[1] The result, as shown in Exhibit II-1, is that District permit fee rates in real, inflation-adjusted dollars have actually declined by 8.54% since 1990.

[1] Scott Owen, Supervising Air Quality Engineer, *Proposed Amendments to Bay Area Air Quality Management District Regulation 3, Fees*, June 24, 1998, page 3.

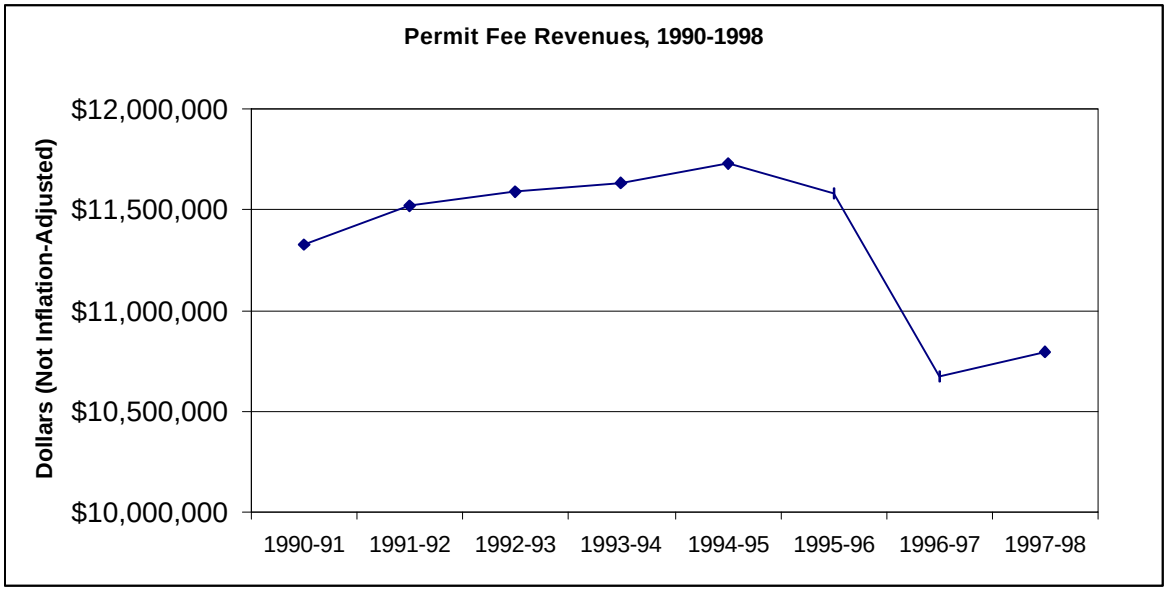
Exhibit II-1: District Permit Fees Compared to Inflation

Year	Consumer Price Index	District Permit Fee Adjustment
1991	4.0%	10.0%
1992	3.2%	0.0%
1993	2.6%	0.0%
1994	1.4%	1.25%
1995	2.1%	0.0%
1996	2.2%	0.0%
1997	3.1%	0.0%
1998	2.7%	3.1%
Compounded, 1991-98	**23.37%**	**14.83%**

Source: *Proposed Amendments to Bay Area Air Quality Management District Regulation 3, Fees*, June 24, 1998. 1998 CPI information is from the US Bureau of Labor Statistics, San Francisco Regional Office. 1998 fee rate increase information is from the Permit Services Division.

Permit fee rates are the basis on which actual permit fee amounts are calculated. Fee rates are used to determine the actual amount invoiced to a regulated facility. As Exhibit II-2 shows, the revenue collected from permit fees has decreased between fiscal year 1990-91 to fiscal year 1997-98, from $11.3 million to $10.8 million.

Exhibit II-2: Permit Fee Revenues (Not Adjusted for Inflation)



Source: Bay Area Air Quality Management District, Approved Budget for Fiscal Year 1998-99, Appendix E. Bay Area Air Quality Management District, Fiscal Year 1997-98, Unaudited Year End Financial Statement, Statement of Revenue

In terms of constant dollars, the decline in permit fee revenues has been even more dramatic. Total permit fee revenue adjusted for inflation has declined by approximately 29% between fiscal years 1991 and 1998.

Overview of this Section

This section contains KPMG's analysis of the District's fee-related revenues and the full costs incurred by the District—through direct staff time, use of equipment and capital, and indirect support activities—to produce the services supported by those fees. Exhibit II-3 presents the permit fees maintained by the District and examined during this cost recovery study (additional information regarding the fee schedules may be found in Appendix B). In addition to the District's fee schedules contained within Rule 3, the study examined penalty revenue from the Mutual Settlement Program.

Exhibit II-3: District Fees Evaluated in the Cost Recovery Study

Fee Schedule	Category of Fee
A	Hearing Board Fees
B	Combustion of Fuel
C	Stationary Containers for the Storage of Organic Liquids
D	Gasoline Transfer at Gasoline Dispensing Facilities
E	Solvent Evaporating Sources
F	Miscellaneous Sources
G1	Distillation/Hydrocracking/Glass
G2	Oil-Water Separation/Refinery Waste Water/Pulping
G3	Crude Distillation/Hydrocracking/Phosphoric Acid
G4	Cracking/Coking/Sulfur Recovery Unit/Acid/Calcining
H	Semiconductor and Related Operations
I	Dry Cleaners
K	Solid Waste Disposal Sites
L	Asbestos Operations
M	Major Stationary Source Fees
N	Toxic Inventory Fees
O	Employer Trip Reduction Fees
P	Major Facility Review Fees
Q	Aeration of Contaminated Soil and Removal of Underground Storage Tanks

Source: Bay Area Air Quality Management District, Rule 3, Amended July 1, 1998.

This section seeks to answer one of the key questions of the cost recovery study: Are fee revenues sufficient to offset associated activity costs? To obtain the information necessary to answer this question, KPMG used a methodology called "activity-based costing" and an automated software tool to analyze the extent of alignment between fee-related revenues and costs. The results of the activity-based costing analysis indicate that the District's fees do not appear to be generating sufficient revenues to recover the actual cost of activities.

In the remainder of this section, KPMG provides an explanation of the activity based costing methodology, a description of the model used in this analysis, and an overview of the results generated from the model.

Activity-Based Costing Explained

Activity-based costing, or ABC, is an approach that communicates information about how resources are consumed by the activities organizations conduct, as well as the outputs created by those activities. ABC structures the analysis to focus on getting cost information not by general ledger line item or program, but instead by activities, processes, and products.

Why use ABC? First, as organizations have become more complex, the elements of cost have shifted and become more mixed. The direct costs of labor and purchased materials to supply services to customers are declining while overhead costs are increasing. These overhead costs represent the costs of technology and people who sustain them, as well as people responsible for providing planning, management, and administrative services. While a straightforward reading of a program's general ledger can provide a good sense of the direct costs incurred by an activity, it is much more difficult to identify how much overhead contributes to an activity's cost. Second, traditional line item or divisional budgets are becoming less effective for managing organizations because of growing dependencies among units and functions. Cross-functional behavior within government agencies is increasing, and public managers are appreciating the interconnectivity and mutual dependencies among their departments. The proliferation in mix, variety, complexity, and diversity, as well as the displacement of direct labor and material costs by overhead, has overwhelmed traditional budgeting and accounting practices.[2] Given these factors, techniques such as ABC allow public managers to better estimate what things actually cost.

ABC systems are built on four components: resources, activities, cost objects, and drivers. Detailed definitions of these components are contained in Appendix F and are summarized below:

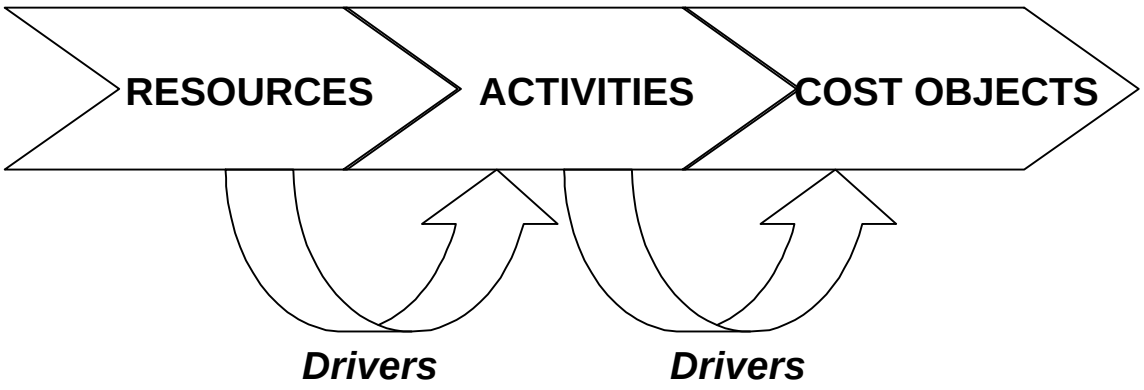
- **Resources** represent the District's personnel, supplies and services, capital, and other factors that allow productive activity and the servicing of customers, whether internal or external.
- **Activities** are what people and equipment do to satisfy the District's mission. Activities are the things that consume resources.
- **Cost Objects** are products, customers, the public, other agencies, or permit holders. They are typically considered the recipient of the service or the outcome of work activities.

[2] Cokins, Stratton, and Helbling, *An ABC Manager's Primer*, Published by the Institute of Management Accountants, 1993.

- **Drivers** are the links, or allocations, that assign (1) resources to activities and (2) activities to cost objects. Drivers reflect unique consumption patterns and link cause and effect to the cost-assignment process. Resource drivers assign costs to activities based on effort expended. Activity drivers measure the frequency and intensity of the demands placed on activities by output-oriented cost objects.

Exhibit II-4 graphically depicts the four components of the ABC approach.

Exhibit II-4: Conceptual Overview of the ABC Approach



Although there are four parts to ABC, activities represent the most critical component of ABC design. The weakness of traditional general ledger reports is that expenses are reported by department and spending account. General ledger reports describe only **what** is spent, while activities describe **how** it is spent. Thus, the most critical task of designing an ABC system is to identify and custom-define the activities managers want to know about; for example, in the District's case, the focus was on fee-related activities, and the ABC model was developed accordingly.

The District's Activity-Based Costing Model

KPMG sought to evaluate the District's existing fee structure to determine the revenue sufficiency of the current schedules. KPMG's approach was to conduct an ABC analysis using an automated software tool to develop a model of the District's revenues, costs, and customers. The ABC software used relational database technology to create trails that link resources to activities and activities to cost objects. The software was also able to generate various types of reports on the costs of activities and the sources of these costs. The ABC model and software made it possible for the cost recovery study team to estimate the direct and indirect costs of all fee-related functions, compare them against fee revenues, and analyze the extent of cost recovery.

KPMG and ABC Technologies, a private consulting firm specializing in ABC modeling, facilitated a three-day workshop with District representatives from the Technical Services,

Permit Services, Planning, and Compliance and Enforcement Divisions. The cost recovery study Project Director also participated. During the three-day workshop, the group developed a preliminary model that represented a first attempt at quantifying the District's resources, identifying high-level services performed by the District, and linking the services to the customers or ultimate recipients of those services. The outcome of these sessions was the District's "Model 0," the very preliminary, first step in tracing the District's flow of dollars through to activities and cost objects.

KPMG next used this "Model 0" to develop "Model 1,"[3] a more detailed breakdown of resources, services, and customers with more accurate numbers and a better set of assumptions. The team that developed Model 0, as well as representatives from the cost recovery study's Advisory Group, Division managers, and other District representatives, reviewed and validated the assumptions behind—and general reasonableness of—Model 1. Based on input from the Advisory Group and District managers and staff, KPMG modified the conceptual underpinnings and assumptions of Model 1.

"Model 1" Design

Identification and Assignment of General Ledger and Capital Costs

The first step to developing the model was to identify resources reported by the General Ledger. Fiscal year 1997-98 actual costs were utilized for Personnel and Service and Supply costs. The lone exception to this assignment method is the reduction to the Information Services program (Program 105) consulting service costs of $1.054 million. This consulting service cost represents the cost of an outside vendor responsible for overseeing the District's effort to migrate its legacy permit services database onto a newer platform. This effort, dubbed the IRIS Project, is intended to streamline the District's permit renewal process and enhance its ability to generate management reports on various aspects of permit activity. KPMG felt that it was important for the ABC model that IRIS costs be represented as part of a capital investment that will be utilized for many years, rather than as an ongoing annual expense.

It is important to include the capital costs related to providing services to stakeholders in the model. In order to do this, estimates of annual capital investment have been made in the model. Capital costs can fluctuate significantly from year to year, and capital investment typically lasts for many years, thus requiring a method to insure that those stakeholders benefiting from the capital investment are paying for that service when the benefit is received.

Capital cost estimates used in the model are based upon a District report written in 1994, "Designated Funds for Capital Replacements." The capital cost amounts and assignment methods used in the model are detailed in Appendix F. While these figures represent annual replenishment rates for a variety of capital investment categories, it serves as a

[3] In doing activity-based cost modeling, it is assumed that numerous iterations of the model will be developed. Thus, it is anticipated that the District will eventually develop "Model 2," "Model 3," "Model 4," and so on, with each generation of the model becoming more accurate.

place to begin further analysis by the District as to the value of the capital that ultimately supports the provision of services to stakeholders.

Assignment of General Ledger and Capital Resources to "Work Groups"

The next step of developing the "resources" module of the ABC model was to assign resources from the general ledger to "work groups," or organizational units. Information was obtained from the District's Administrative Services Division and from budget data on the resources used by each of the District's different programs. Costs for Personnel, Service and Supplies, and Capital were assigned to each work group, based upon the programs that each group manages.

The method of assignment of capital resources is meant to reflect the primary drivers of consumption by each work group based upon the type of capital resource that is being distributed. For example, building costs are assigned to work groups based upon estimates of the percentage of the building occupied by each work group. In some cases, the use of resource drivers based upon counts was supplemented by adding weights to the counts based upon the intensity of the demands placed upon the resources by the work group. For example, allocating vehicle costs based on number of vehicles assigned to each work group is supplemented by applying "weighting factors" that emphasize the initial higher costs of certain vehicles, or higher mileage and greater wear-and-tear on cars driven by certain work groups. While not a perfect determination of resource cost assignment, which could require a great deal of time and money to more accurately determine, this method attempts to approximate actual usage and costs.

Assignment of Overhead Work Group Resources to Direct Output Work Groups

Some activities performed by District staff result in the provision of direct services to external stakeholders like the public and regulated industries. Other divisions and programs within the District exist to support other units in delivering direct services to these external stakeholders. A goal in developing a full cost model is to capture both direct and overhead costs, e.g., human resources and system development, and service outputs.

Often, organizations apply a single overhead rate to all of its activities. This implicitly assumes a linear relationship between direct and overhead costs, and is not a practical view. For example, a 10% increase in District service outputs would not likely require a 10% increase in Human Resource staff or building space. On the other hand, the District has not attempted to quantify any overhead costs associated with fee-related activities. Consequently, the District has failed to consider a significant, and possibly growing, cost related to fee activities. The model that has been developed for the District is designed to make clear the unique relationships between the variety of direct and overhead costs triggered by performing activities.

The model used for this study assigned overhead resources such as human resources and administration to direct service groups based upon estimates of how direct service work groups consume these overhead services, i.e., the cost drivers. For example, human

resource costs are assigned to other work groups based upon quantity of personnel assigned to each work group, i.e., FTE. This method approximates the consumption of payroll and benefits administration services, for example, by each work group. By recognizing the unique relationships between overhead and direct resources, costs attributed to overhead work groups are reassigned to direct service groups.

Assignment of Work Group Costs to Activities

As stated previously, identification of the right activities to be used in the ABC model is essential. A list of activities for the District's ABC model was developed based upon discussions with the District staff and a review of the fiscal year 1997-98 program budget in order to distinguish how work group resource costs were absorbed in performing the various District activities. The District activities are organized in the model by District program. Just as the resources were assigned to work groups, the work group costs are assigned to the various activities. The primary drivers utilized to perform this exercise were percent of labor effort and distribution of work group FTEs among activities.

Assignment of District Activities to Cost Objects

Once the direct and overhead costs are assigned to different activities, these costs are then reassigned to the selected cost objects, or service outputs. There are a variety of service outputs, some of which are revenue producing, and some not. The following are the general groups of cost objects:

- Direct Permit Holders (including Permits, CEQA, Toxic, Title V, Penalties, and Hearing Board)
- Public at Large (including Citizen Complaints/Inquiries, Area Source Programs, Public Education, and Community Assistance)
- Other Agencies/Districts (including Federal and California EPA, and Monterey)
- Service Fees
- TFCA Projects and Administration
- Business Sustaining.

The "Business Sustaining" group of cost objects recognizes activities performed by the organization, primarily the Executive Office and Governing Board, which are of a strategic nature. These activities take place regardless of changes in service output volumes. Thus, a change in service output volumes does not drive additional use of these activities or resources. The remaining outputs do place demand on activities. Working with District staff, estimates were made of the level of demand by different cost objects on the various activities. In some cases, only one or two activities were performed to create an output, in other cases, a variety of different activities, at differing levels of demand for those activities, were required to create specific cost outputs. District staff members estimated the demand on activities by cost objects. The service output cost assignment estimates are included with the descriptions of the resource and activity cost assignments in Appendix F.

ABC Model Caveats

In reviewing the results of the model, the reader is reminded that there are a number of constraints that affect how the information ought to be interpreted. These caveats are briefly mentioned below.

- **Time and data constraints**
  The model is the best that could be achieved given the brief schedule of this cost recovery project, the resources available to KPMG and the District during that time frame, and the information that could be easily accessed during that period. Furthermore, the ABC model that has been developed is a static snapshot of a specific time period (fiscal year 1997-98). As such, it is a model of the best approximation of the relationship between resources, activities, and cost objects for that particular period. The results of this particular model should not be generalized and used as a forecast for potential fee revenues and activity costs for any past or future period.

- **Level of detail**
  The activities identified in this model are at a fairly general level of detail. With more specific activities, the accuracy of the model could potentially be improved.

- **The model contains estimates, assumptions and approximations**
  There are a variety of cost drivers that can be utilized to describe and model the behavior of how each resource is consumed. ABC modeling professionals usually point out that the better the drivers, the better the model. Because of the lack of available information regarding transaction volume data within the District, the model utilizes estimates by employees within the District who are considered to be knowledgeable in the subject matter. These estimates will affect the accuracy of rates of consumption of resources by activities, and the demands placed upon activities to create specific outputs.

- **This model was the District's first attempt**
  This model represents the introduction of ABC concepts to District staff. Learning the vocabulary and techniques of ABC modeling, especially for individuals without background in cost accounting, can be difficult. District representatives participating in developing the model should be commended for how quickly they learned the concepts of ABC and how well they provided usable information for the model.

ABC Model Results

The goal of the ABC modeling exercise was to estimate the full cost incurred to provide a variety of fee-related services for District stakeholders, and to compare those costs against the revenues paid by those stakeholders. The model sought to make assignments for direct, indirect, overhead, capital, and other relevant costs associated with each of the District's fee-related activities. The model then linked the various activities to specific service outputs. Finally, the model compared the full cost of service outputs against the revenue from each fee schedule. Again, it should be noted that the model relies on numerous assumptions and, consequently, the results from the model are subject to possible inaccuracies.

Exhibit II-5 documents the results of the model's calculations. It compiles fiscal year 1997-98 District costs by service output and shows the variance, or funding gap, between those costs and their associated revenues. The results of the model highlight several critical points about the District's fee-related cost recovery in fiscal year 1997-98:

- The estimated shortfall between permit fee revenues and activity costs was approximately $7 million in fiscal year 1997-98. As can be noted in Exhibit II-5, four fees (new and modified, and permit renewal fees E, F, and I) are the largest contributors to this shortfall.
- The information presented in Exhibit II-5 suggests that the District's non-fee revenues are being used to bridge the gap between fee revenues and activity costs. It appears that the District relies significantly on county revenue to support its fee-related activities.
- Exhibit II-5 indicates that positive variances—instances where revenues are exceeding the costs of activities—may be occurring. The largest example of a positive variance is Schedule M—Major Sources, with $1.3 million positive variance of revenues over activity costs. Schedule M is a fee regulation that stipulates that the District shall collect from each major stationary source emitting 100 tons per year or more of organic compounds, sulfur oxides, and/or nitrogen oxides a fee of $36.05 per ton. This schedule is entirely emissions-driven and therefore bears no relationship to the cost of District activities
- The overall variance between District total revenues and costs is shown in the last line of Exhibit II-5. This $3.7 million negative variance is basically comprised of two elements: 1) the inclusion of $4.7 million in capital expenses in the model when the District's expenditures were only $580,000; and 2) $700,000 in operating expenditures in excess of revenues. Capital expenses in the ABC model included the costs for the building, which the District did not amortize during fiscal year 1997-98, and other capital assets. These costs were captured in the ABC model to reflect the full range of resources being utilized in order to provide regulatory activities.

Exhibit II-5: Comparison of Actual Fee Revenues vs. Estimated Activity Costs

	Fiscal Year 1997-98				
	Revenue *		Expenditures ~		Variance
PERMIT FEES	**38.8%**	**$10,421,280**	**56.1%**	**$17,110,000**	**-$6,688,720**
New & Modified Fees	**4.6%**	**$1,228,412**	**10.6%**	**$3,230,000**	**-$2,001,588**
Permit Renewal Fees	**22.6%**	**$6,062,800**	**36.7%**	**$11,210,000**	**-$5,147,200**
B - Combustion		$1,588,644		$1,560,000	$28,644
C - Storage Tanks		$1,281,841		$1,050,000	$231,841
D - Bulk Plants/Terminals		$80,188		$210,000	-$129,812
D - GDFs		$475,220		$850,000	-$374,780
E - Solvent Evaporation		$852,427		$3,220,000	-$2,367,573
F - Miscellaneous		$491,985		$2,010,000	-$1,518,015
G1 - General		$132,742		$250,000	-$117,258
G2 - General		$103,610		$80,000	$23,610
G3 - General		$264,916		$80,000	$184,916
G4 - General		$579,499		$660,000	-$80,501
H - Semiconductor		$105,350		$80,000	$25,350
I - Dry Cleaners		$87,699		$1,040,000	-$952,301
K - Waste Disposal		$18,678		$120,000	-$101,322
Facility Fees	**11.7%**	**$3,130,068**	**8.7%**	**$2,670,000**	**$460,068**
M - Major Source		$2,062,598		$780,000	$1,282,598
P - Title V		$653,749		$1,180,000	-$526,251
District Toxics		$215,455		$630,000	-$414,545
Bubble/Emissions Banking		$198,265		$80,000	$118,265
OTHER FEES	**4.5%**	**$1,199,416**	**6.8%**	**$2,070,000**	**-$870,584**
A - Hearing Board		$13,225		$650,000	-$636,775
L - Asbestos		$797,201		$800,000	-$2,799
N - Toxics Inventory Fees (AB 2588)		$375,000		$540,000	-$165,000
Q - Soil Aeration		$13,990		$20,000	-$6,010
California Environmental Quality Act (CEQA)		$0		$60,000	-$60,000
COUNTY REVENUE	**35.3%**	**$9,471,590**	**12.2%**	**$3,720,000**	**$5,751,590**
Business Sustaining				$960,000	
Public At Large				$2,470,000	
Other Agencies				$290,000	
TRANSPORTATION FUND FOR CLEAN AIR	**6.8%**	**$1,832,352**	**8.2%**	**$2,500,000**	**-$667,648**
AB 434 TFCA - Admin		$715,108		$1,220,000	-$504,892
AB 434 TFCA - Project		$1,117,244		$1,280,000	-$162,756
STATE SUBVENTIONS	**4.9%**	**$1,313,592**	**4.4%**	**$1,340,000**	**-$26,408**
FEDERAL GRANT	**4.5%**	**$1,212,299**	**10.2%**	**$3,120,000**	**-$1,907,701**
CONTRACTS	**1.0%**	**$271,477**	**1.5%**	**$460,000**	**-$188,523**
PENALTIES	**3.3%**	**$882,124**	**0.5%**	**$140,000**	**$742,124**
INTEREST	**0.5%**	**$145,823**			**$145,823**
OTHER REVENUE (Copies, Service Fees, Subscriptions, etc.)	**0.4%**	**$115,642**	**0.2%**	**$60,000**	**$55,642**
TOTAL (AB434 and AB2588 Pass Thru Funds Excluded)	**100%**	**$26,865,595**	**100%**	**$30,520,000**	**-$3,654,405**

* - Unaudited Year End Financial Statement adjusted to exclude pass-through funds.
~ - Data are results from the third ABC Model Run (2/10/99), rounded to nearest 10,000 to reflect range of error from estimates.

Source: Activity-Based Costing Model and Bay Area Air Quality Management District, Fiscal Year 1997-98 Unaudited Year-End Financial Statement.

Exhibit II-5 summarizes the fee revenue and cost information generated from Model 1 and identifies over- and under-funded fee services and programs. The ABC model's results presented in Exhibit II-5 indicate that there were certain fee schedules in fiscal year 1997-98 for which revenues were not adequate to reimburse the District for the costs of providing the fee program. The results from model contained in Exhibit II-5 helped shape the development of several of short- and long-term recommendations for fee adjustments contained in this report. More importantly, this information will hopefully serve as a useful a starting point for the District and its Board to evaluate the overall effectiveness and sustainability of its fees.

III. SHORT-TERM FEE ADJUSTMENTS

Years of spending down its fund balance have left the District vulnerable to program and staff cuts when fee revenues decline. Consequently, there is an urgent need to take action to restore the District's financial footing. The purpose of this section is to provide the District with some readily implementable ideas for securing its fee revenues.

In developing the recommendations presented here, KPMG sought information from District managers and staff on the background, context, and issues related to the District's fees and associated program costs. KPMG interviewed District employees who have responsibility for performing fee-related activities and overseeing fee revenues, including representatives from the following organizational units: Executive Office, Hearing Board, Legal, Permit Services, Compliance and Enforcement, Planning and Research, Technical Services, and Information Systems. These interviews served to provide the cost recovery study team with background on the District's fees and related activities. This information was supplemented with benchmarking and comparative analysis of how other districts have attempted to keep their fee revenues at adequate levels to fund activity costs.

From the combined efforts of interviews, benchmarking, and developing the ABC model, KPMG accumulated data and information that resulted in the specific recommendations for adjusting fees in the short term presented below. These opportunities meet the requirements identified by the District for short-term recommendations: they should be implementable between four months to two years, and be cost neutral to the District. The District imposed the time and cost considerations that limit the range of short-term recommendations because it is currently transitioning its permit information and billing database onto a new system. This project is anticipated to be completed in 2000-01 and will require the attention of District managers and adequate financial support in District budgets. To accommodate these factors, the short-term recommendations presented in this section are intended to be relatively straightforward to implement, as well as inexpensive.

In addition, these short-term fee adjustments will satisfy the legal standards circumscribing the District's fees.[1] Any recommended adjustments for permit fees may not exceed actual costs for district programs for the immediately preceding fiscal year, with an adjustment not greater than the change in the annual California Consumer Price Index, up to a maximum single-year increase of 15%.

[1] The Office of District Counsel, in a July 31, 1998, memorandum, noted that the District must be able to rationally articulate reasons for a fee increase and, specifically, must be able to show: (1) what costs are being supported by that type of fee and; (2) why that decision is fair based on benefits from and burdens to the regulatory system; and (3) why it is fair to apportion the costs among the various different fee payers as may be proposed within each fee structure or schedule.

Short-Term Findings and Recommendations

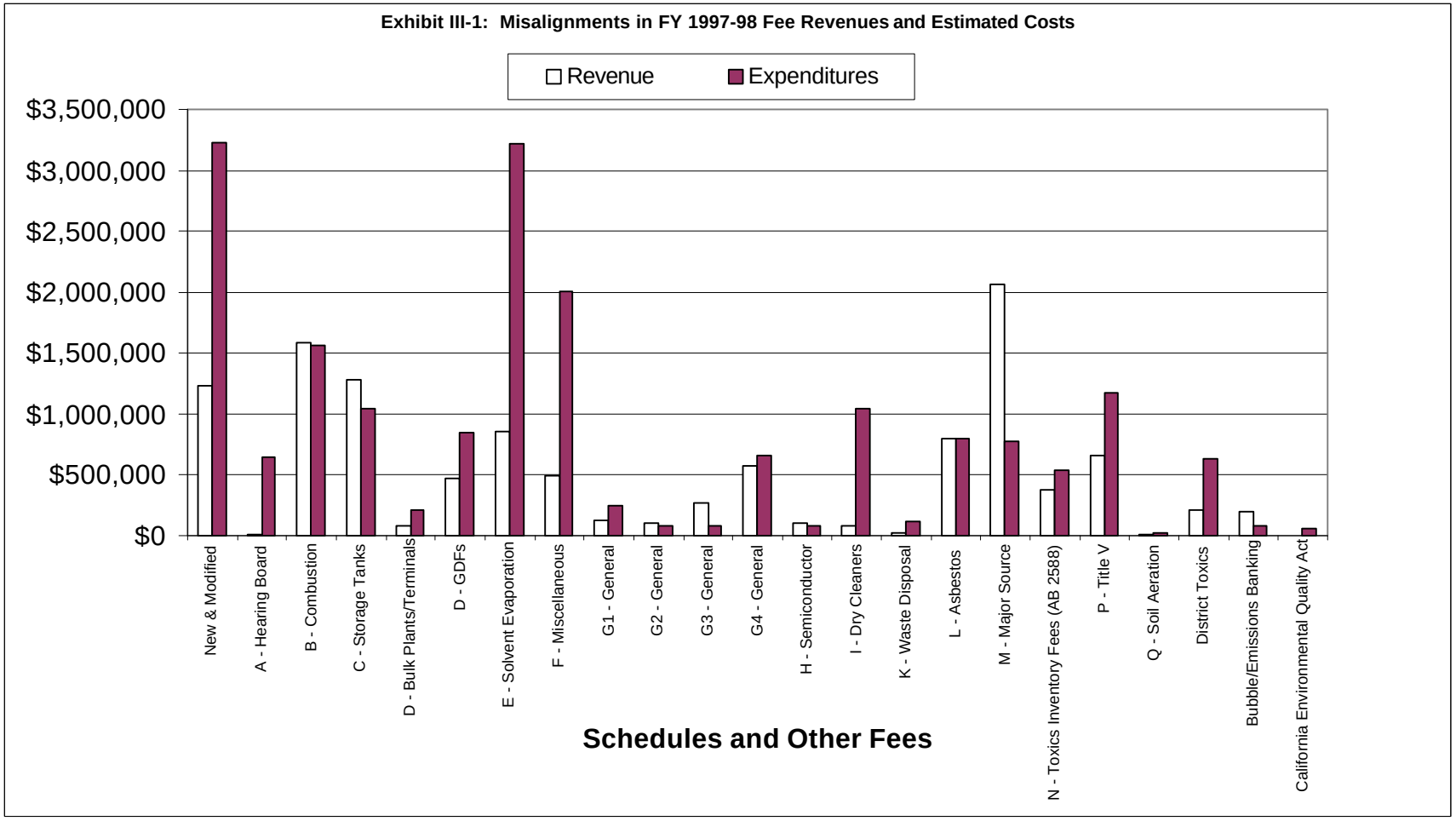
Finding #1: **The District needs to increase its fee schedules so that fee revenues offset a larger portion of the costs associated with the District's regulatory activities.**

In a July 31, 1998 memorandum, the District's Legal Counsel examined the applicable statutory principles associated with permit and other fees. The California Health and Safety Code states that an air pollution control district may adopt a schedule of fees for the evaluation, issuance, and renewal of permits to recover the cost of District programs related to permitted stationary sources. The District's permit fees may be used to recover all costs, including indirect costs, of that program.

Given that the District is authorized to recover all costs of its regulatory programs through fees, it seems reasonable that the District should endeavor to do so. Thus, one of the fundamental questions this study sought to answer was, "are fee revenues set at sufficient levels to offset the costs of regulatory activities?" The simple answer to this question is no—fee revenues are not recovering the costs of activities. As the results of the ABC model indicate, the District's permit and other fees fell approximately $7 million short of full cost recovery during fiscal year 1997-98. It is very likely that this misalignment between fee revenues and costs contributed to the District's $700,000 operating revenue shortfall for fiscal year 1997-98.

The ABC model showed that the extent of misalignment varied according to fee schedule. A comparison of fee revenues against activity costs for new and modified permits, renewal permits, and other fees is presented in Exhibit III-1 on the following page, and serves to illustrate how the schedules differed in their extent of cost recovery during the previous fiscal year.

Exhibit III-1: Misalignments in FY 1997-98 Fee Revenues and Estimated Costs



Source: Activity-Based Costing Model and Bay Area Air Quality Management District, Fiscal Year 1997-98 Unaudited Year-End Financial Statement.

A review of the ABC model's results, as summarized in Exhibit III-1, indicates noticeable lack of alignment between revenues and costs for the District's new and modified permit fee program, as well as several renewal fee schedules. Exhibit III-2 highlights those fee schedules where the potential misalignment between revenues and costs may be significant, on the order of half a million dollars or more. The District should undertake further refinement of the ABC model as well as further critical validation of the model's assumptions and entered data to ensure that the significant negative variances shown in the specific fee schedules listed in Exhibit III-2 are correct.

Exhibit III-2: Schedules Indicating Greatest Potential Shortfalls Between Fee Revenues and Costs

Schedule	FY 1997-98 Revenues	Estimated Activity Costs	Potential Shortfall
Schedule A: Hearing Board	$13,225	$650,000	-$636,775
Schedule E: Solvent Evaporation	852,427	3,220,000	-2,367,573
Schedule F: Miscellaneous Sources	491,985	2,010,000	-1,518,015
Schedule I: Dry Cleaners	87,699	1,040,000	-952,301
Schedule P: Title V	653,749	1,180,000	-526,251

Source: Activity-Based Costing Model Run (2/10/99).
Note: Only those permit renewal schedules with a potential shortfall of over $500,000 are listed in this exhibit. The reader should be aware that the above information is subject to a wide range of possible error due to assumptions in the model.

District staff have stated that the ABC model's results confirmed their intuition about where the costs of activities were significantly exceeding fee revenues. For example, staff of the District's Compliance and Enforcement Division have long known that annual renewal fees for Schedule I were far under-recovering the costs of staff effort (including compliance assistance and inspection activities) undertaken on behalf of dry cleaners. Through the use of the ABC model, the extent of this shortfall has finally been estimated.

There are several factors that may contribute to the shortfalls between fee revenues and associated activity costs:

- **Inflation costs have not been fully addressed**
  As already discussed in Section II, the District's fee schedules have not even kept pace with inflation. Consequently, approximately 9% of the gap between fee revenues and costs can be attributable simply to inflation.
- **Subsidies and discounts exist for small business**
  The District has made a conscious decision to provide fee "discounts" for small businesses to ensure that regulatory fee costs are not unduly burdensome. Such discounts are clearly articulated in Schedule A—Hearing Board, wherein variance fees paid by entities qualifying as a "small business" as defined within Schedule A are one-fourth to one-third the fee paid by a "large company." In addition, the District's Regulation 3-302.1 provides "an applicant who qualifies as a small business shall pay one half of the filing fee." Finally, small businesses such as local

dry cleaning operations are subsidized insofar as the District has never attempted to recover the full costs of providing compliance and enforcement activities to these operations.

- **Capital costs were not previously identified**
  One factor contributing to the misalignment between fee revenues and associated activity costs is the fact that neither capital nor overhead costs have been assigned to programs and their activities. As a result, the District has never completely calculated the full resource burden of its various fee-related activities.

- **Fees are based on a source's size and potential capacity to produce emissions, not on the costs of providing regulatory activity.**
  Since 1977, the District has calculated its permit fees based on the capacity of equipment and/or other factors that approximated the potential volume of emissions that could be generated by a particular source. However, an "emissions surrogate" does not necessarily correlate with the level of effort that the District must expend in order to process a permit. Because fee revenues are not based on actual costs of activities, misalignments occur.

- **The model contains numerous assumptions.**
  The negative variances may also be the product of the numerous estimates, assumptions, and guesses used by the project team in order to populate the model.

These and other potential causes of the misalignment between fee revenues and costs need to be quickly addressed by the District to ensure that shortfalls do not reoccur in subsequent years. Additional factors, other than those identified above, may have contributed the misalignment between the District's fee revenues and activity costs. However, as a starting point and at a minimum, the District should quickly undertake steps to mitigate the potential negative fiscal effects that result from failure to adjust fees for inflation, a small business subsidy, not including capital costs, and performing more labor-intensive work.

Recommendation #1.1:	**The District should adopt a 9% to 15% fee schedule increase in fiscal year 1999-2000 to begin to provide sufficient fee revenue to fund its regulatory activities.**

KPMG recommends that the District's Board approve an increase in fee schedules. A fee schedule increase can be justified based on the fact that the District's fee schedules have not kept pace with inflation, and on the results of the ABC model.

The District's fee schedules are currently 9% lower today than they were back in 1991. As a consequence, the actual revenues calculated based on those fee schedules have also declined. Actual permit fee revenues have dropped from approximately $11.3 million in fiscal year 1990-91 to $10.4 million in fiscal year 1997-98. Even worse, in terms of constant dollars, the District's fee revenue has declined by approximately 29%.

The ABC model's results indicate that expenditures for permit related activities were approximately 60% higher than fee revenues during fiscal year 1997-98. Based on current assumptions and estimates, the model has calculated that permit fee revenues fell approximately $7 million short of activity costs. Therefore, to begin to realign fee revenues and costs, the District will need to increase its schedules to begin to recover the 60% gap.

The District should seek a fee increase between 9% (representing a 1990-1998 inflation adjustment) and 15% (representing the annual maximum possible adjustment). A 9% increase represents the lower bound to a prudent fee adjustment, and should be adopted at a very minimum. The 9% increase would compensate for the fee schedules' not increasing with inflation during the 1990's. In addition, recalling that there was a $700,000 operating shortfall during fiscal year 1997-98, a fee schedule increase of 9% would help provide an estimated $900,000 in additional revenues that could prevent another year of operating deficits. At the opposite end of a possible fee schedule adjustment, Health and Safety Code Section 41512.7 limits any single year permit fee increase to 15%. Given the District's 60% misalignment between fee revenues and costs, seeking the maximum allowable fee increase of 15% would not be unreasonable.

Recommendation #1.2:	**The District should consider instituting a policy to make fee adjustments every year to account for inflation.**

One approach that could help better align the District's fee revenues and costs is to institute a policy to automatically adjust fee schedules based on the annual Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) published by the Federal Bureau of Labor Statistics for the urban Bay Area region (San Francisco-Oakland-San Jose). Such an approach would allow the District to keep up with increasing costs from inflation.

The advantage to this approach is that it would allow fees to track with personnel expenditures, currently the most significant component of the District's costs. The District's salaries are increased periodically to provide cost of living adjustments for employees. As a result, the District's personnel expenditures rise along with the cost of living. Having an automatic annual inflation adjustment for fee schedules will enable the District to recover this increase in costs.

However, possible drawbacks to this approach are its potential inaccuracy and inflexibility. It may not necessarily be the case that the District's costs to provide regulatory activities will increase at the rate of inflation. Indeed, the level of staff effort—and resulting activity costs—may be higher than inflation for certain industries in particular years. Alternatively, permit streamlining and other efforts to improve the District's performance efficiency may result in lower costs of service. Another consideration is that, for reasons of public policy, the Board and District may wish to retain discretion in making fee adjustments, rather than being locked into an inflexible CPI increase each year.